# Office of Chief Counsel Internal Revenue Service

# memorandum

CC:LM:MCT:DET:TL-N-2427-00 ERSkinner

date:

to:

Territory Manager, Retailers, Food & Pharmaceuticals, LM:RFP

Sarolta Ficsor, Team Manager

Attn: Larry Bayer, IE

from:

LMSB Counsel, Detroit, Michigan

subject:

, FYE

I.R.C. §§ 451, 862 - Recognition of Foreign Source Royalty Income

This memorandum is in response to your request for advice regarding stiming for recognition and character of royalty income received from pursuant to a revised royalty agreement. The advice in this memorandum is subject to post-review in the National Office, which we will expedite. If you have any questions, please call the undersigned at (313) 237-6426.

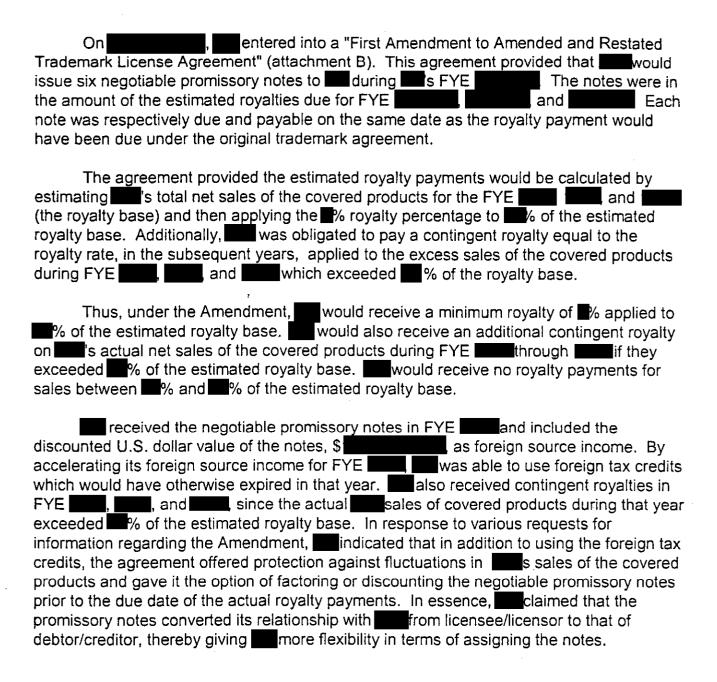
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This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

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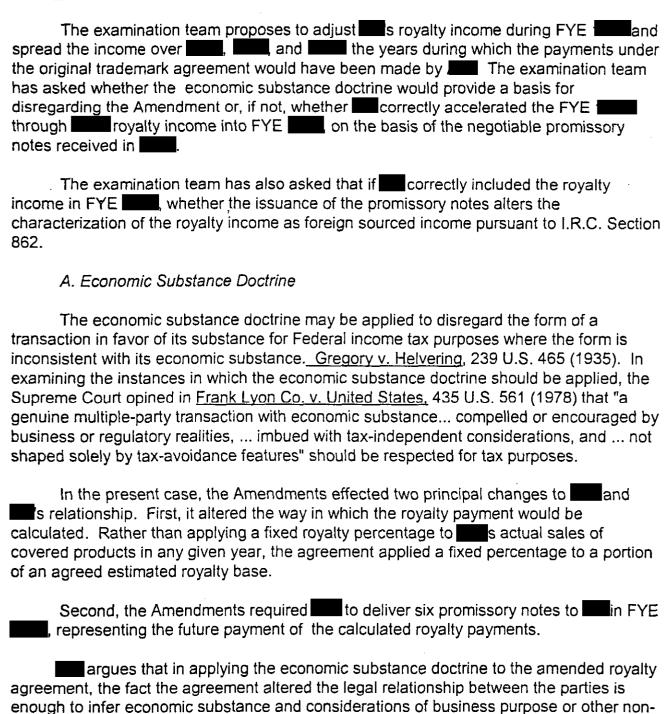
# Issues

I. Whether the discounted value of promissory notes received from in that year.
II. If the promissory notes constitute income to such income U.S. sourced or foreign sourced for purposes of computing 's foreign tax credit allowance.
Conclusions
I. The discounted value of promissory notes received from in should be included in its income for that year.
II. The income recognized as a result of the promissory notes received during is foreign sourced income pursuant to I.R.C. § 862.
Facts
("") entered into an initial Trademark Licensing Agreement with "") on "This agreement authorized to manufacture and sell within Japan certain products upon which wowned trademark, tradename and manufacturing intangibles. The agreement detailed specific products and established a royalty rate based upon the volume of sales of those products within Japan. The actual royalty payment was due after determined the sales of the covered products.  On and and amended the initial agreement titled "Amended and Restated Trademark Licensing Agreement" (attachment A)("the Amendment"). the Amendment called for to issue "demand promissory notes" to during the siscal year ended in an amount equal to an estimated royalty for the covered products for and and promissory notes in FYE ""."
is a Japanese entity originally formed, and who owned by During , who stock was distributed to the shareholders. After the distribution, approximately who stock was offered for sale to the public and became a publicly traded company.
<sup>2</sup> The examination team adjusted 's FYE income tax return to deferring the income attributable to the promissory notes until the due dates of the respective notes. Appeals' subsequent resolution reflected 's partial concession of the issue.



### Discussion and Analysis

## Issue I. Income Recognition



tax motivated considerations are unnecessary.<sup>3</sup> cites <u>Kraft v. Commissioner</u>, 232 F.2d 118 (2d Cir, 1955) as its principal authority for this interpretation. However, that interpretation is untenable in light of the recent string of opinions which look beyond whether the form of the transaction merely altered the legal relationship of the parties. <u>See ACM Partnership v. Commissioner</u>, T.C. Memo. 1997-115, and <u>Compag v. Commissioner</u>, 113 T.C. 17 (1999).

In <u>Compag v. Commissioner</u>, 113 T.C. 17 (1999), the Court specifically noted that "To satisfy the business purpose requirement of the economic substance inquiry, 'the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and ... economic situation." <u>Id</u>. at 22, <u>citing ACM Partnership v. Commissioner</u>,157 F.3d 236.

In the present case it is,important to note, for purposes of applying the economic substance doctrine, that the underlying royalty agreement establishing the licensor/licensee relationship between and had been in place since and the economic substance of that relationship/agreement is not in question. At issue here is the change to the royalty agreement which provided the additional tax benefits by accelerating royalty income into to use expiring foreign tax credits.

Having noted the differing views on the application of the economic substance doctrine in the present case, the facts indicate the amended royalty agreement possessed economic substance and a business purpose other than tax- avoidance considerations. Specifically, the agreement insulated from the spossible sales fluctuations during FYE through from the from the spossible sales fluctuations during received a discount in the amount of royalties paid based on the estimated royalty base. Additionally, spossible sales fluctuations during based on the estimated royalty base. Additionally, spossible sales fluctuations during received a discount in the amount of royalties paid based on the estimated royalty base. Additionally, spossible sales fluctuations during received a discount in the amount of royalties paid based on the estimated royalty base. Additionally, spossible sales fluctuations during the amount of royalties paid based on the estimated royalty of transactions which accelerate income for services, royalties, rents, etc., and requires such prepaid income to be included in income in the year it is received. See Rev. Rul. 60-85, 1960-1 CB. Thus, the amended royalty transactions should not be disregarded for federal income tax purposes since they possess economic substance.

<sup>&</sup>lt;sup>3</sup>In response to a request for additional information from the examination team, submitted a memorandum discussing the application of the economic loss doctrine to the amended royalty agreement. (See attachment C)

B. I.R.C. Section 451

I.R.C. Sec. 451. Provides in part that:

General rule for taxable year of inclusion.

(a) General rule. The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

A taxpayer using the accrual method of accounting must include an item in gross income when all the events have occurred that fix the right to receive the income, and the amount of such income can be fixed with reasonable accuracy. Treas Reg. Sec. 1.451-1(a). It is well established that a taxpayer must include in income, for the year of receipt, the fair market value of a negotiable promissory note of a responsible and solvent maker. Scharf's Estate v. Commissioner, 316 F. 2d 625 (7th Cir. 1963), affg. 38 T.C. 15 (1962);and Barnsley v. Commissioner, 31 T.C. 1260 (1959).

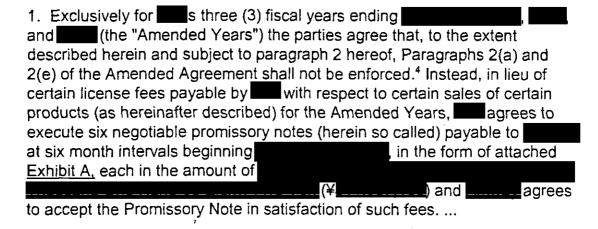
In the present case, received six negotiable promissory notes in FYE Each note represented one-sixth of the total amount of the estimated minimum royalty payment due under the amended royalty agreement. The value of the notes was properly converted from yen to U.S. dollars and discounted to present value to determine the amount of income includible as income for FYE Each.

Thus, properly included the discounted value of the notes as income in FYE

Issue II. Character/Sourcing for the income realized by upon receipt of the promissory notes

Generally, for international tax considerations, the source of royalty payments is determined by the place where the property (to which the royalty payment relates) is located or used. I.R.C. Section 862(a)(4). The intangibles giving rise to sobligation to pay royalties to are located and used in Japan. Thus, it would appear the royalty payments should be foreign sourced income pursuant to I.R.C. Sec. 862(a)(4). The present case, however, presents a unique issue since the royalty income recognized in is not predicated on the receipt of actual royalty payments but rather receipt of negotiable instruments, the amounts of which were determined by reference to future royalty payment obligations.

In relevant part, the First Amendment to the Amended and Restated Trademark License Agreement provides as follows:



The provision above clearly shows the negotiable promissory notes were given "in lieu of" and "in satisfaction of" the estimated (and agreed) royalty payments due from to for the lieu. And the lieu of the lieu

Pursuant to the origin of the claim doctrine set forth in <u>U.S. v. Gilmore</u>, 372 U.S. 39 (1963), the character or classification of payments for Federal income tax purposes may, in certain circumstances, be based on the underlying facts giving rise to the payment. The origin of claim doctrine has traditionally been used to characterize legal expenses for Federal income tax purposes by the origin of the claim litigated. <u>See Woodward v. Commissioner</u>, 397 U.S. 572 (1970). However, courts have extended the origin of claim doctrine to the characterization of Title VII damage recoveries, looking to the nature of the claimed injury as the basis for the taxability of the damage award (i.e., personal or economic); <u>see</u>, <u>e.g.</u>, <u>Roemer v. Commissioner</u>, 716 F.2d 693, 697 (9th Cir. 1983). In such cases, the payments may be characterized in accordance with the type of action or claims upon which the lawsuit was originally based. Applying this rationale to the present case, the promissory notes (and thus the related income recognized in would be considered royalty income received for suse of the intangible property. As such, the note payments represent the payment of royalties and the income classified as foreign sourced income.

Given the negotiable nature of the promissory notes, could have factored or discounted them to a third party in order to receive cash during. Such a transaction, however, would not have altered the analysis above since conversion of the promissory

<sup>&</sup>lt;sup>4</sup> Those provisions set forth an original payment arrangement whereby would pay the calculated royalty payments semi-annually in and

<sup>&</sup>lt;sup>5</sup>The audit team indicates held the promissory notes until maturity.

notes to cash less a discount merely changes the form, i.e. from notes to cash, of payment not the substance of the underlying (royalty) transaction upon which the character of the income is based. Similarly, any third party redeeming such factored or discounted promissory notes from at the maturity date would not recognize foreign source royalty income since the origin of the income (as analyzed by applying the same principles stated above) to the third party is the factoring/discounting transaction with

If you have any further questions concerning this matter, please feel free to telephone the undersigned at (313) 237-6426

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By:

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As stated